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REPLY BRIEF FOR PETITIONER

In the Supreme Court of the United States.

OCTOBER TERM, 1931

No. 349

OLD COLONY RAILROAD COMPANY, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

J. S. Y. IVINS,
Attorney for
Old Colony Railroad Company,
c/o Brewster, Ivins & Phillips,
Southern Building,
Washington, D. C.

Of Counsel:
Kingman-Brewster,
O. R. Folsom-Jones.

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of course, one factor. The prosperity of the obligor's business; its future prospects, the value of the mortgaged property securing the bond, the condition of the money market, determined largely by general business conditions, the competition among lenders, even current crop forecasts and prospects of political parties in approaching elections affect the price at which a bond will sell, and that price is likely to vary not only from day to day but from minute to minute. In attempting to sustain their theories, the accountants quoted in the Government's brief below reason in circles. One of them says:*

> "If the credit of the company and the conditions of the market would have enabled the company to issue a five per cent twenty-year bond at par, its six per cent bond, running at the same time, should sell at approximately 112.46."

Of course it should in order to sustain the theory. If the theory will sustain the premise, the premise in turn will sustain the theory. But can the Government prove by any evidence on which a court could make a finding of fact that his six per cent bond would have sold at 112.46? Any one who has had any experience in the securities market knows that at one time long term bonds will sell "to yield" a higher rate than short term bonds of equal security, and at other times the short term bonds will be preferred. If the bidders are under the general impression that interest rates are likely to decline, they will prefer long term bonds in the hope not only that they will receive in later years higher rates of interest than would then be obtainable on new investments, but that they will also be able to realize an increased principal price on the resale of the bonds. On the other hand, if purchasers foresee higher interest rates, they will prefer short time securities which will mature and be paid, thus putting

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* Government's brief below, p. 17.

them in funds to reinvest at the expected better interest rates.

The same kind of difference exists between bonds carrying interest at rates high enough to sell at a premium and bonds carrying interest low enough to sell at a discount. A man who invests $110 in a premium bond expects a higher rate of interest because he will get back only $100 at maturity. The difference in interest rate will compensate him for the lesser amount to be received at maturity. Conversely with the purchaser of bonds at a discount. We do not question that to some extent this compensation goes to adjust the difference between par and the selling price of the bond. But to assume that there is any exactness about it and that the purchaser would have taken the same bonds at par "to yield" the same return is just as unsafe as to assume that a purchaser would be equally willing to buy long term bonds or short term notes "to yield" the same return. The same factors that influence the purchaser of short time notes to desire to get his money back soon, will induce him to buy bonds at a premium. And the same factors that induce another to prefer long term bonds, will induce him to prefer bonds selling at a discount.

We are now concerned with a 1921 income tax case. The Revenue Act of 1921 imposed the income tax in the same phraseology as the Revenue Act of 1918, reenacting the language in the light of the departmental construction contained in Article 544 of Regulations 45. It adopted the principle quoted on p. 7 above, which is wholly inconsistent with the Government's new theory. And every Revenue Act and every Treasury Regulation since has done the same thing. The legislative intent in the 1921 Act can be found in the departmental construction of the 1918 Act.* But, as held by the Circuit Court

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* *National Lead Co.* v. *U. S.*, 252 U. S. 140, 146; *Brewster* v. *Gage*, 280 U. S.; 327, 337.

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REPLY BRIEF FOR PETITIONER

Statement

Petitioner respectfully refers the Court to the brief printed with the petition for a writ of certiorari, which is relied upon as petitioner's brief in chief upon the merits.

The facts are set forth in the petition (p. 2 thereof). The facts are stated in more detail in the brief for respondent (pp. 2–7).

The Government originally claimed that the premiums received on the sale of bonds constituted income—gain derived from capital. After the decision of the Circuit Court of Appeals in the first test case,[1] holding that the premiums were income, but not taxable if realized before March 1, 1913, it changed its ground and urged a wholly inconsistent theory—that the premiums were not income but that the deduction for interest paid

[1] *Commissioner* v. *Old Colony Railroad Co.*, 26 Fed. (2d) 408.

should be limited. In its brief before this Court the Government seems to be trying to rely upon both theories at the same time saying at some points that the premiums are gross income[1] and at others that they are not.[2] Despite the confusion in the Government's brief it is clear that the Government's position must be either (1) that the premiums are to be included in gross income for 1921 although realized before March 1, 1913, or (2) that the taxpayer is not entitled to deduct "all interest" under section 234(a) (2) because the deduction allowed by Congress is excessive.

Summary of Argument

The $6,960.64 added by the Government to petitioner's gross income for 1921 was not income to the petitioner in that year, but had become part of its capital before March 1, 1913.

The Treasury Department had no right to reduce the deduction for "all interest paid on indebtedness" provided by the statute.

If any part of the interest paid should be excluded from petitioner's deductions, it should be equally excluded from its income represented by interest paid by its lessee.

Premiums are realized when bonds are sold, discounts when they are redeemed. Congress may tax premiums received after March 1, 1913 and may permit the tax to be spread over the life of the bonds, but it cannot tax premiums received before March 1, 1913. It may, in its discretion, allow deductions for discounts, whenever realized. Accordingly, decisions with respect to discounts do not necessarily apply to premiums where the bonds were sold prior to March 1, 1913.

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[1] e.g. p. 2, line 7; p. 22, line 2.

[2] e.g. p. 15, line 26; p. 16, line 7; p. 20, line 25; p. 21, third line from bottom.

The methods of accounting adopted by the Interstate Commerce Commission for its own purposes, which do not involve the effective date of the Sixteenth Amendment, are not controlling for the purposes of computing taxes under the Revenue Acts.

ARGUMENT

I.

Section 234(a)(2) of the Revenue Act of 1921 permitted the petitioner to deduct from its gross income "all interest paid or accrued within the taxable year on its indebtedness" without limitation. There is no authority in law for reducing this deduction by a proportion of premiums received on the sale of the bonds.

The problem under consideration is a question of statute law and should not be confused by theories evolved to justify bookkeeping methods proposed by accountants. The important factor, which does not concern theorizing accountants, nor Interstate Commerce Commissioners compiling data for regulating railroad rates, is the effective date of the Sixteenth Amendment to the Constitution.

An accountant, theorizing on gain and loss, would say that if A bought an asset in 1894 for $100 and sold it in 1921 for $200, he had a gain of $100. But for income tax purposes we can only treat as taxable that part of the gain found by the accountant to have been realized in 1921 which resulted from increment subsequent to March 1, 1913.[1] Similarly, the Interstate Commerce Commission, for the purpose of making rates might require a railroad company to deduct depreciation on the basis of the cost of assets acquired in 1905, but in computing an income tax we must take the March 1, 1913 value for a base.

[1] *Lynch* v. *Turrish* and other cases cited in first footnote on p. 8 of brief annexed to petition for certiorari.

The Treasury Department by a series of unchanging regulations, ruled that premiums received on the sale of bonds constituted **gain or income.**[1] The regulations required this **income** to be pro-rated or amortized over the life of the bonds, rather than included in gross income in the year of receipt. Whether the first of these regulations was sound need not concern us, for the reenactment of the statutory basis of the regulation, without change, constituted a Congressional approval thereof in the Revenue Act of 1921, applicable to the present case.

But the regulations contained nothing to indicate any intention to cover premiums on bonds sold before March 1, 1913, and the reenactment of the statute did not adopt any such application.

When the Circuit Court of Appeals held in the Old Colony Railroad's 1920 case[2] that the regulations did not apply to premium-income actually received prior to March 1, 1913, the Government, in order to justify taxing such income, brought forth for the first time its present theory, which **repudiates** all the regulations, in spite of their Congressional adoption by repeated reenactments, and insists that premiums received on the sale of bonds are **not income,** but that they can nevertheless be taxed, even when realized before March 1, 1913, by the process of holding that the provision for deduction of all interest paid does not mean what it says.

The administration proposes a theory under which it can effectively tax income received before 1913. This is substantially parallel to the legislative attempt to tax exempt interest received by insurance companies, condemned by this Court in *National Life Ins. Co.* v. *United*

[1] Regulations 45, Art. 545, etc., see footnote "§" p. 11 of brief annexed to petition for certiorari. Article 848 quoted in Government's brief deals only with discounts, not premiums, and applies only to computation of invested capital, where the effective date of the Sixteenth Amendment is in no way involved.

[2] 26 Fed. (2d) 408.

States, 277 U. S. 508. If income from municipal bonds cannot be effectively taxed by a statutory limitation on deductions, calculated to nullify the exemption, certainly income realized prior to 1913 cannot be taxed through an administrative distortion of the statutory provision which allows the deduction of all interest on indebtedness.

The petitioner undertook, in a typical bond,[1] "to pay to the bearer * * * on the first day of December A. D. 1925, the sum of One Thousand Dollars * * * together with interest thereon at the rate of four per cent per annum, payable on the first days of June and December in each year on the presentation and surrender of the annexed coupons * * *", a typical coupon reading: "On the first day of June 1896, the Old Colony Railroad Company will pay to the bearer * * * Twenty Dollars, being six months interest on its bond No. 0000."

We submit that the indebtedness was $1000, the interest was $20 each half year, that the $20 was all income to the bondholder and not partially a return of capital,[2] and that the whole $20 was interest on indebtedness deductible by the railroad, and not partially a repayment of a principal debt. See point II of brief annexed to petition for certiorari.

The converse of the present question was presented in *Henrietta Mills Inc.* v. *Commissioner*.[3] The taxpayer

[1] R. p. 65.

[2] No part of it being deductible as a return of capital or amortization of premium—*New York Life Ins. Co.* v. *Edwards*, 271 U. S. 109; cf. Treasury ruling known as Office Decision 622, 3 C. B. 89, which reads:

> "Interest received or accrued on bonds purchased at a premium, according to the method employed in keeping books, represents income for the year in which received or accrued at the rate carried by the bonds and not at the rate which would be realized after amortizing the premium."

[3] 52 Fed. (2d) 931, C. C. A., 4th, June 30, 1931, affirming 20 B. T. A. 651.

in 1920 purchased 2000 shares of stock and contracted to pay $650 per share for 500 shares on April 1, 1920, $680,875 per share for 500 shares on January 15, 1921, $719,875 per share for 500 shares on January 15, 1922, and $758,875 per share for 500 shares on January 15, 1923. The Circuit Court of Appeals said:

> "It is contended by the petitioner that the purchase price of all the stock was $650.00 per share as of April 1, 1920, that the total purchase price was to be paid in four installments, and that the excess of the later over the first price amounted to what would have been six per cent. interest and was in fact interest. It is further contended on behalf of the petitioner that to give the contract any other interpretation would be illogical and utterly ridiculous from a business standpoint.
>
> "We cannot agree with petitioner's contention. The courts will not disregard the plain language of a contract or interpolate something not contained in it. Here the language used by the parties is clear and unambiguous, and cannot be ignored however plausible the reasons advanced The courts will not write contracts for the parties to them nor construe them other than in accordance with the plain and literal meaning of the language used. [citations]
>
> "The fact that the later installments exceeded the first by amounts that equaled six per cent. does not of itself prove that the excess was interest. * * *
>
> "Tax liabilities must be determined by what in fact was done. *Remington Rand Inc.* v. *Commissioner of Internal Revenue*, 33 Fed. (2) 77. *United States of America* v. *C. W. Phellis*, 257 U. S. 156."

Congress had power to allow the deduction from gross income of any items it saw fit. It did allow the deduction of all interest, not merely of what the accountants call "effective" interest. The statute contains

nothing diminishing the deduction by what the accountants call "excess interest."[1]

Bond premiums are income as the Regulations have always stated. They are recognized as such by Congressional reenactment in the light of the Regulations. Such of them as were realized prior to 1913 are not within the scope of the income tax law, and they cannot be reached by administrative amendment to the statutory provision allowing deduction of interest.

The Board of Tax Appeals, after careful study, rejected the Government's new theory in *Fall River Electric Light Co.* v. *Commissioner*, 23 B.T.A. 168, and rendered a detailed and well reasoned opinion approving the Regulations which the Government here seeks to repudiate. In *Connecticut & Passumpsic Rivers R.R. Co.* v. *Commissioner*, 24 B.T.A. 394, the Board considered itself controlled rather than convinced by the decision here under review, stating that it regarded the Regulations as correct, but applying them to premiums received before 1913. We submit that the reasoning of the Board in the first of these two cases was correct, and that, in the second, it erred in taxing, as income, premiums realized before 1913.

II.

If the petitioner's deduction for interest should be reduced as the Government insists, its income should be similarly reduced in the same amount.

As the Government says [brief p. 37] the payment of the interest due on the petitioner's bonds by its lessee in reality constitutes additional rent on which the petitioner, as lessor, is liable to pay income taxes. Accordingly it reported in 1921 $538,920 as income—that being the full amount of interest paid by the New Haven in

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[1] Note that they still call it "interest," even though "excessive" for the purposes of their transcendental theory.

that year on the Old Colony bonds. It claimed a deduction of the same sum, as interest paid.

Now the Government says it was not all interest, but in part repayment of a loan. If $6,960.64 of the second item was not interest but a principal repayment, then $6,960.64 of the first item was not interest either. The New Haven was obliged to pay the petitioner's interest out of its own pocket, but it never undertook to pay the petitioner's principal debts without charging them back or refunding them with new obligations to be executed by the petitioner.

So if $6,960.64 was not interest, the New Haven, in paying it should charge it to the petitioner, just as it charges it with the face amount of bonds which it may retire without refunding. If the item is charged to the petitioner it certainly is not income. If A pays B's butcher's bill for him, the payment may be income to B, but not if B becomes simultaneously indebted to A for the same amount.

If the $6,960.64 was not properly interest, then the petitioner erroneously included that much in the $538,920 which it reported as income. If this error be corrected, it will offset the adjustment the Government wants made to petitioner's item of deductible interest, and there will be no aditional tax to assess.

III.

The rule as to amortization of discounts has no application to premiums, where the bonds were issued before March 1, 1913.

If A sells a $1,000 bond for $1,100 he has a gain of $100, realized at the time of sale. He has actually received $100 more than he has undertaken to repay at maturity. If B sells a $1,000 bond for $900 he will sustain a loss when, at maturity he must pay $1,000. If A

and B kept their accounts on a cash basis, A should properly report his gain in the year of sale of the bond, and B should properly deduct his loss when he realizes it—that is, when he has to pay the $1,000. If they report on the accrual basis, it is reasonable, as the Regulations permit, to treat both alike and amortize both premium and discount.

But if the bonds were sold before March 1, 1913 and mature after that date the situations of A and B are entirely different. A realized his gain at a time when there was no income tax—no constitutional authority for an (unapportioned direct) income tax; but B will realize his loss at a time when the Sixteenth Amendment and the statutes thereunder are in full effect. The income tax law cannot (nor does its language indicate any intent to) reach back and tax A on a gain realized before 1913, but Congress is at perfect liberty to permit B to deduct his loss, when he realizes it. Congress could permit the deduction of the entire loss in the year of maturity of the bond, or, if it saw fit, could deny B any deduction for his loss. Or Congress could allow him to deduct a fraction of his loss. The Government, admitting that what is income is controlled by the Contsitution, has always insisted that deductions are a statutory concept, wholly within the legislative discretion of Congress. The Board of Tax Appeals recognized this position of the Government in the *Rock Island* case quoted on pages 26 and 27 of the Government's brief.

The construction placed upon the statute by the Regulations allows only a partial deduction for the loss suffered by B in the hypothetical case. If his bond ran for 20 years, 10 of them before and 10 after March 1, 1913, he would be allowed to deduct one-half of the loss—five per cent of it in each year after March 1, 1913. We need not quarrel with this rule—everybody seems satisfied with it.

But because Congress is held by the Treasury Department to have intended, in its discretion, to allow B to deduct half his loss (all of which is actually realized in 1923) in ten installments from 1913 to 1923, it does not follow that Congress was at liberty to or intended to tax A on half his gain, **all of which was realized in 1903.**

Accordingly we submit that the Board of Tax Appeals was correct in its reasoning in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner*, 13 B. T. A. 988, 1027 ff., wherein it allowed the taxpayer to deduct a fraction of the loss by bond discount, in each year after 1913, although the bonds had been sold before 1913 and at the same time recognized the soundness of the ruling of the Circuit Court of Appeals in the first *Old Colony Railroad* case to the effect that premiums realized before 1913 could not be taxed thereafter.

IV.

The method in which petitioner's books were kept in 1921 does not justify the proposed tax.

When the petitioner's bonds were sold in 1894–1905 it was not an operating company. All its property except the corporate seal, stock books, etc., was under lease to the New Haven Railroad.[1] Under the terms of the lease the bonds were issued on the demand of the New Haven, which decided the interest rate to be paid (for the New Haven was obliged to pay that interest). When the bonds were sold, a premium was realized. We contend that this realization benefited only the New Haven—for the Old Colony received no increased rental—and could not benefit the Old Colony until the termination of the lease.

But, for the purposes of this point, we may ignore the fact that the Old Colony was precluded from enjoying

[1] R. p. 42.

the benefit until 1992 and assume that it got beneficial ownership of the premiums received at the time of their receipt in 1894–1905.

At that time the Interstate Commerce Commission was not interfering with petitioner's bookkeeping. The premiums were entered in a capital account entitled "Premium on Bonds."[1] Not being capital contributed by stockholders, presumably the premiums must have been income before they became capital. They were not borrowed money, for there was no obligation to repay them.

The Interstate Commerce Commission, for the purpose of fixing rates, evolved a system of bookkeeping which it imposed on the petitioner **over its protest.** The Commission required the petitioner to set up new accounts and amortize the premiums over the life of the bonds. If the petitioner had known that these accounts would (years later) be regarded as controlling for income tax purposes, it would probably have litigated the right of the Commission to compel it (a non-operating road which made no rates) to report as income in subsequent years something which it had previously realized. But, since rates made by the Commission could not affect the rents it would receive from the New Haven, it decided that it was cheaper to comply than to contest the ruling.

The Government tries to give the impression that the petitioner treated a part of the premiums on its books as income for 1921. On page 16 the Government's brief so states, with a qualification only mentioned in a footnote. The fact is that the petitioner on its books did not treat any part of the premiums as income for 1921. It merely transferred a part from one capital account ("Bond Premiums") to another capital account ("Profit and Loss"). Moreover, a charge or credit to "Profit and Loss" on books kept under the direction of the

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[1] R. p. 45.

Interstate Commerce Commission may deal with an item actually realized for income tax purposes in an earlier year. This is exemplified in the *Kansas City Southern* case cited below.

Now the Treasury insists that because the Interstate Commerce Commission, for its general purposes, requires the petitioner (for whom no rates are fixed, because it operates no railroad) to amortize the premiums in its returns to the Commission—those premiums, received in 1894–1905, become income taxable in 1921.

The controlling effect of the accounts kept under the supervision of the Interstate Commerce Commission is a point on which the Treasury usually takes the opposite position. *Kansas City Southern Ry. Co.* v. *Commissioner*, 16 B. T. A. 665, was a case where the taxpayer, having, in 1909, abandoned certain property in the process of improving its road, was required by the Interstate Commerce Commission to charge the cost of such property to operating expenses and was permitted to spread the deduction over fifteen years. Aliquot parts of the cost being thus charged off in 1918 and 1919, the taxpayer claimed deductions therefor on its income tax returns. The Treasury Department insisted that Interstate Commerce accounting could not control for purposes of the income tax and was upheld by the Board. On appeal the Circuit Court of Appeals for the Eighth Circuit affirmed the Board and upheld the Treasury Department,[1] saying, inter alia:

> "The Commission did not purport, in requiring the loss for abandonment to be charged to operating expenses to provide any standards for tax authorities to follow. This would be beyond its province. * * * Systems of accounting for railroads under the control of the Commission cannot interfere with the Government's system of

[1] — Fed. (2d) —, Aug. 31, 1931.

taxation. The Commission has no power to direct how the Revenue Laws of the United States shall be interpreted or by its orders provide standards to govern the taxing authorities."

As the Board of Tax Appeals said in *Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner*, 13 B. T. A. 988, 1027:

> "We can see no merit in the respondent's action in so far as it is dependent upon the manner in which the account is reflected upon the books. Bookkeeping entries can not control over the actual facts, and if necessary they should be corrected to correspond with the true facts. If the bond discount is to be disallowed as a deduction the denial must rest on more substantial grounds."

The Interstate Commerce Commission, for rate making purposes, allows railroads to deduct their income taxes in computing their income. The Treasury Department always disallows this deduction.

In *Fall River Electric Light Co.* v. *Commissioner*, 23 B. T. A. 168, the taxpayer was under control of the Massachusetts Department of Public Utilities. Under the rules of that Department, the taxpayer was permitted to elect whether to treat bond premiums as income in the year of sale, in the year of maturity, or ratably over the life of the bonds. It elected to treat them as income in the year of maturity. But the Treasury Department insisted on disregarding the books of account, approved by the controlling State Department, and taxed the premiums as income ratably over the life of the bonds. It was upheld by the Board.

CONCLUSION

The Regulations treat bond premiums as income. The Treasury and the petitioner agreed that this was sound, but the petitioner contended that such income, received before March 1, 1913, was not taxable. The Circuit Court of Appeals so held. Now the Government, despite its denial of doing so, repudiates the Regulations and urges that the premiums are not income, offering a new theory that conflicts with the statute permitting the deduction of "all interest."

Although repudiating the theory of the Regulations in order to reach income realized before March 1, 1913, the Government falls back, in its "Conclusion," upon the proposition that the Regulations have been uniformly applied to billions of dollars of railroad indebtedness. But the Government neglects to mention that all but a very small part of those billions are represented by bonds sold after March 1, 1913, bonds sold at par, bonds sold at discounts, and especially bonds issued in exchange for property, where the question before this Court is in no way involved.

The Government, in the last paragraph of its brief, would have this Court believe that the decision of this case will affect bonds to be issued in the future. Nothing could be further from the truth. The Regulations unquestionably apply to all bonds issued after March 1, 1913.

The decision of the Circuit Court of Appeals should be reversed.

J. S. Y. Ivins,
Attorney for
Old Colony Railroad Company.

Of Counsel:

c/o Brewster, Ivins & Phillips,
Southern Building,
Washington, D. C.

Kingman Brewster
O. R. Folsom-Jones